11. Assets Securitization

Concept of Securitization : *Securitization is a carefully structured process by which a pool of loans and other receivables are packaged and sold in the form of asset-backed securities to the investors to raise the required funds from them.* Through this process relatively illiquid assets are converted into securities. Securitization falls under the broad category termed as structured finance transactions.

Structured finance refers to securities where the promise to repay the investors is backed by the value of the underlying financial asset or the credit support of a third party to the transaction or some combination of the two. Thus, securitization is nothing but liquefying assets comprising loans and receivables of an institution through systematic issuance of financial instruments.

Structured financing instruments are derivatives of traditionally secured debt instruments where the credit standing of the instrument is supported by a lien on specific assets or by some other form of credit enhancement such as a guarantee. With a conventional secured bond, the primary source of repayment of the bond is still the earning power and cash flow of the issuer.

In a securitized transaction, the burden of repayment on the bond shifts away from the issuer to a pool of assets or to a third party. The cash flows from the pools of assets which have been securitized provide the funds for repayment to the bond.

Securitized transaction is termed as structured transaction because through specific choices relating to the type and amount of assets in the pool and particular features of the transaction, these securities may be structured to achieve a desired level of risk and a desired level of rating.

Securitization is said to have taken place when a company's assets are removed in one way or the other form from its balance sheet and are funded instead by investors. The investors receive tradable financial instruments evidencing the investment without recourse to lending institution. The entire transaction, from the accounting point of view, is carried out on the asset side of the balance sheet, that is, one asset gets converted into another.

Mechanism of Securitization

Typically, the mechanism of securitization is outlined below :

(i) The process of securitization starts with identification by the company (the originator) the loans or bills receivable in its portfolio, to prepare a basket or pool of assets to be securitized. The package usually forms an optimum mix so as to ensure fair marketability of the instrument to be issued.

Further, the maturities are also so chosen that the package represents one homogeneous lot. The pool of receivables is backed by the underlying securities held by the originator (in the form of mortgage, pledge, charge, etc.).

(ii) The pool of assets so identified is then sold to a specific purpose vehicle (SPV) or trust. Usually an investment banker performs the task of an SPV, which is also called an issuer, as it ultimately issues the securities to investors.

(iii) Once the assets are acquired by SPV, the same are split into individual shares/ securities which are reimbursed by selling them to investors. These securities are called 'Pay or Pass Through Certificates' (PTC) which are so structured as to synchronize for redemption with the maturity of the securitized loans or bills.

A PTC thus represents a sale of an undivided interest to the extent of the face value of the PTC in the aggregate pool of assets acquired by the SPV from the originator.

(iv) Repayments under the securitized loans or bills keep on being received by the originator and passed on to the SPV. To this end, the contractual relationship between the originator an the borrowers/obligates is allowed to subsist in terms of the pass through transaction; alternatively a separate agency arrangement is made between the SPV (Principal) and the originator (agent).

(v) Although a PTC could be with recourse to its originator, the usual practice has been to make it without recourse. Accordingly, a PTC holder takes recourse to the SPV and not the originator for payment to the principal and interest on the PTCs held by him. However, a part of the credit risk, as perceived (and not interest risk), can be absorbed by the originator, by transferring the assets at a discount, enabling the SPV to issue the PTCs at a discount to face value.

(vi) The debt to be securitized and the PTC issues are rated by rating agencies on the eve of the securitization. The issues by the SPV could also be guaranteed by external guarantor-institutions to enhance creditability of the issues. The PTCs, before maturity, are tradable in a secondary market to ensure liquidity for the investors.

From the above, it is evident that the primary participants involved in the issuance of securitization transaction are the originator, obligors, the SPV, the servicer and the credit enhancer. The originator has the assets which are sold or used as collateral for the assets backed securities. Originators are generally manufacturing companies, financial institutions, banks and non-banking finance companies.

The term obligors' refers to borrowers who have taken loans from the originators resulting in the creation of the underlying asset. The SPV or trust raises funds to buy assets from the originator by selling securities to investors. It uses the cash flow generated by the financial assets in the pool to pay interest and principal to investors and covers its own costs. The servicer/receiving and paying agent is responsible for collecting principal and interest payments on assets when due and for pursuing the collection from delinquent accounts.

The service is usually the originator or an associate of the originator. The credit enhancer provides the required amount of credit support to reduce the overall credit risk of a security issue. Credit enhancement is provided by the originator in the form of senior- subordinate structure over collateralisation or through a cash collateral. Third party credit enhancement generally takes the form of a letter of credit or a surety bond.